



The Conference Board

Economic Road Maps 1985 Index

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ECONOMIC ROAD MAPS

Eva Culen, Editor

Chuck N. Tow, Chief Chartist

The Conference Board Inc.
845 Third Avenue, New York, N.Y. 10022
(212) 759-0900 Telex 234465 and 237282

The Conference Board of Canada
255 Smyth Road
Ottawa, Ontario, K1L-6R3, Canada
(613) 746-1261

The Conference Board, Inc.
Avenue Louise, 207 Bte 5
B-1050 Brussels, Belgium
(02) 640 62 40 Telex 63635



Corporate Profits: An Introduction

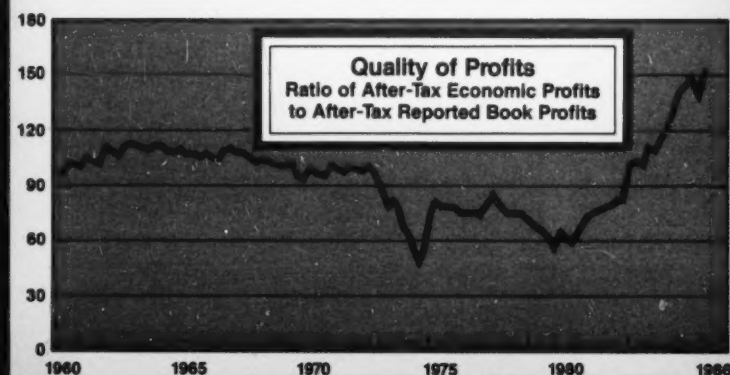
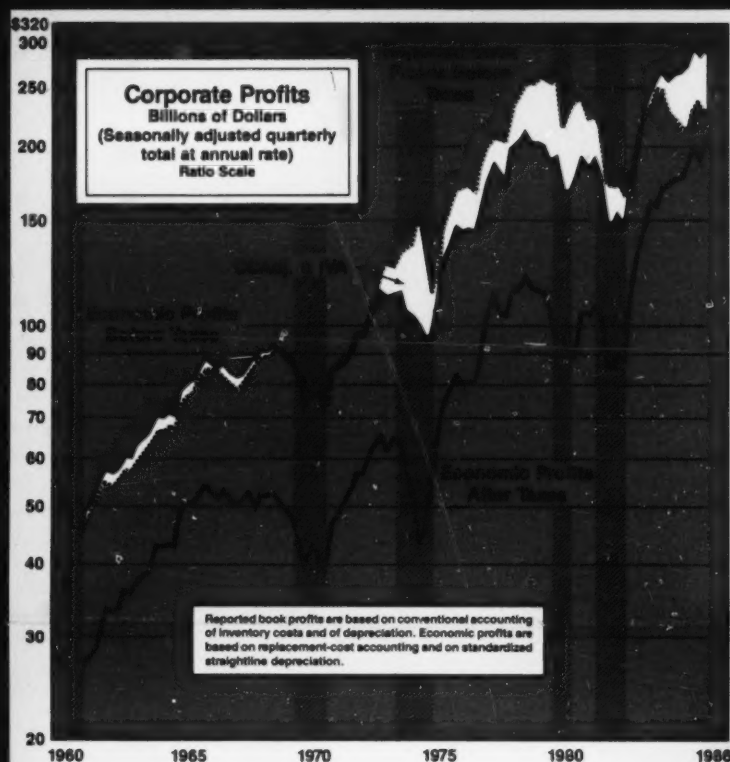
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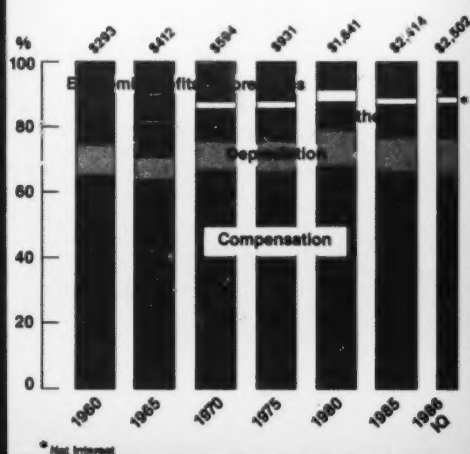
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Corporate profits, which usually rebound dramatically in the initial stage of an economic recovery, have fluctuated widely during the business cycles of the last 25 years. Corporate profits in the last three years can be viewed as weak or strong, depending on which National Income Accounts (NIA) measures are chosen. Reported after-tax profits have

been sluggish during the current expansion, averaging only 8.3% growth at annual rates. But these figures can be deceiving since measures of reported profits are not the best indicators of financial health. NIA reported profits are based on the difference between receipts and expenses (including depreciation) as reported for tax purposes.



Components of Gross Domestic Corporate Product
Billions of Dollars

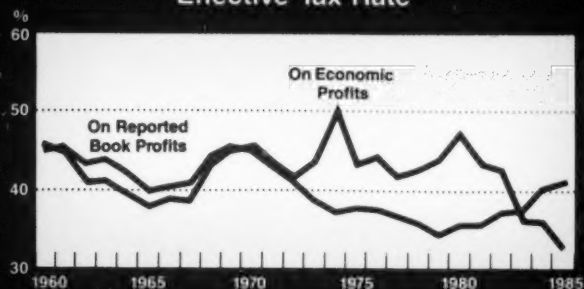


Economic profits, on the other hand, adjust the reported figures to reflect inventory and depreciation charges at replacement cost. Hence, they are better gauges of corporate earnings. During the current expansion, economic profits grew an average of 31% annually.

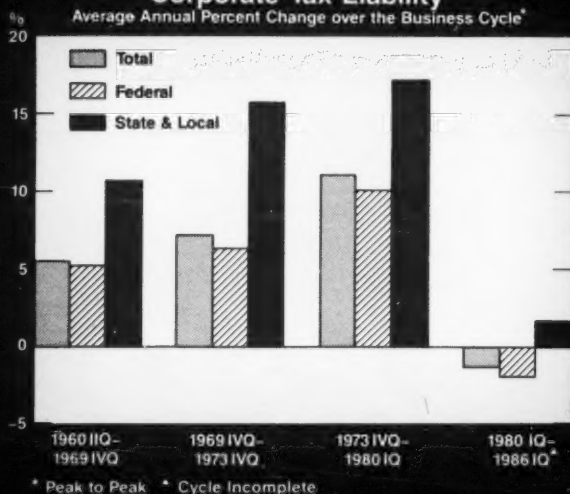
The surge in economic profits has dramatically improved the quality of profits—roughly measured as the ratio of economic to reported profits. While both profit measures moved closer together in the 1960s, reported profits surpassed economic profits during the 1970s. That trend has been reversed since 1983 as economic profits became stronger. Moreover, taxes have declined in relation to economic profits since they are based on reported figures. Similarly, the average annual growth of corporate tax liability declined in the 1980s after a period of steady growth in the 1970s.

The difference between reported and economic

Effective Tax Rate



Corporate Tax Liability



and a replacement valuation, CCAdj. has surged since the 1981 tax changes.

Table 1 highlights the dramatic swing in the IVA and CCAdj. since the late 1970s, when inflation was still rampant and before the corporate tax relief was enacted. Thus, economic profits have risen dramatically relative to reported profits—the result of lower inflation and faster depreciation allowances.

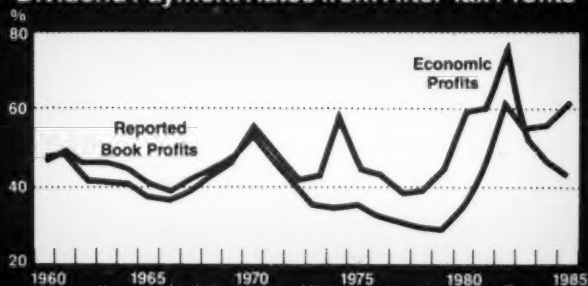
Table 1

Effects of the tax break and lower inflation on profits
\$ Billions

	1980	1985	Change
After-tax reported profits	\$152.3	\$131.4	\$ -20.9
IVA	-43.1	.6	42.5
CCAdj.	-16.8	58.1	74.9
After-tax economic profits	92.4	188.9	96.5

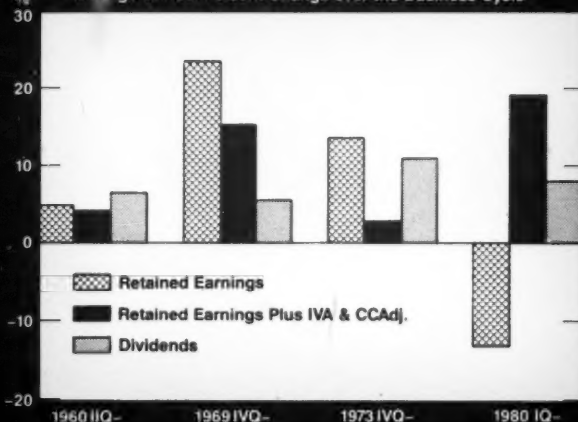
The two corrections in reported profits have implications for the trends in the dividend payout rate and in retained earnings. Looking only at reported profits, the dividend payout rate appears to have increased since 1980. But in terms of economic profits, it actually declined. This is good news for U.S. companies, since retained earnings with IVA and CCAdj. grew faster

Dividend Payment Rates from After-Tax Profits



Dividends & Retained Earnings

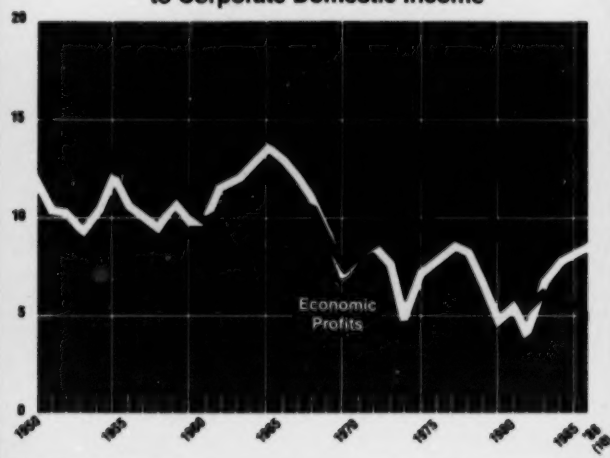
Average Annual Percent Change over the Business Cycle*



Composition of Pretax Economic Profits



Ratio of Domestic After-Tax Profits to Corporate Domestic Income

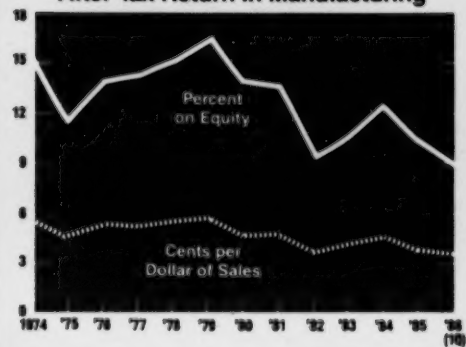


in the 1980s than during the 1970s, leaving corporations with more funds for new investment.

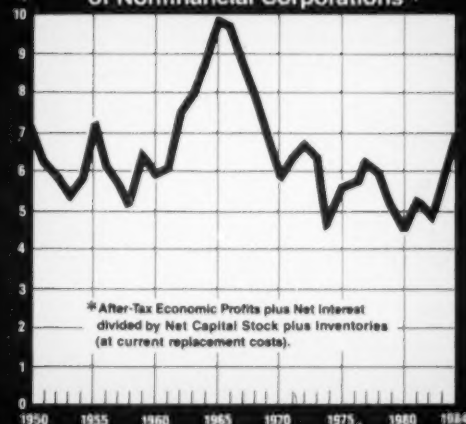
The surge in economic profits has improved the profitability picture. In the last three years, shares of corporate domestic income have shown an upward trend after a dramatic decline in the 1970s. The rate of profit on the capital stock also seems to have recovered somewhat. Its poor performance in the 1970s had economists concerned about the efficiency of corporate operations.

In contrast, profitability measures for manufacturing appear to have been rather sluggish during the current expansion. This cannot be explained simply by the pressures of foreign competition that the manufacturing sector faced when the dollar was strong. Since these measures exclude IVA and CCAdj. and are based on reported profits, they probably overstated profits in the 1970s and understate them in the 1980s.

After-Tax Return in Manufacturing

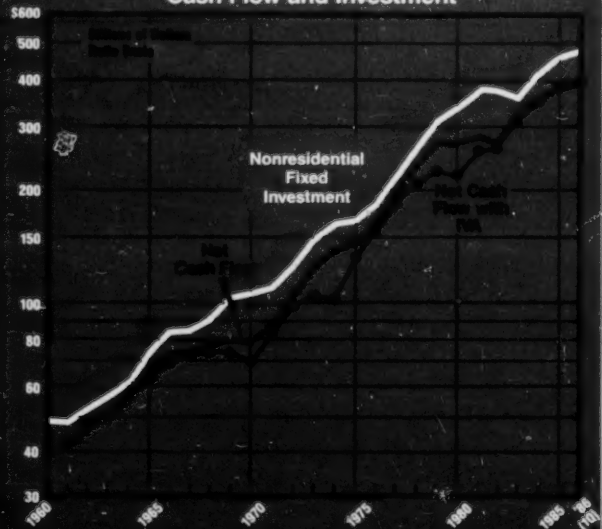


After-Tax Return on Capital Stock of Nonfinancial Corporations *



* After-Tax Economic Profits plus Net Interest divided by Net Capital Stock plus inventories (at current replacement costs).

Cash Flow and Investment



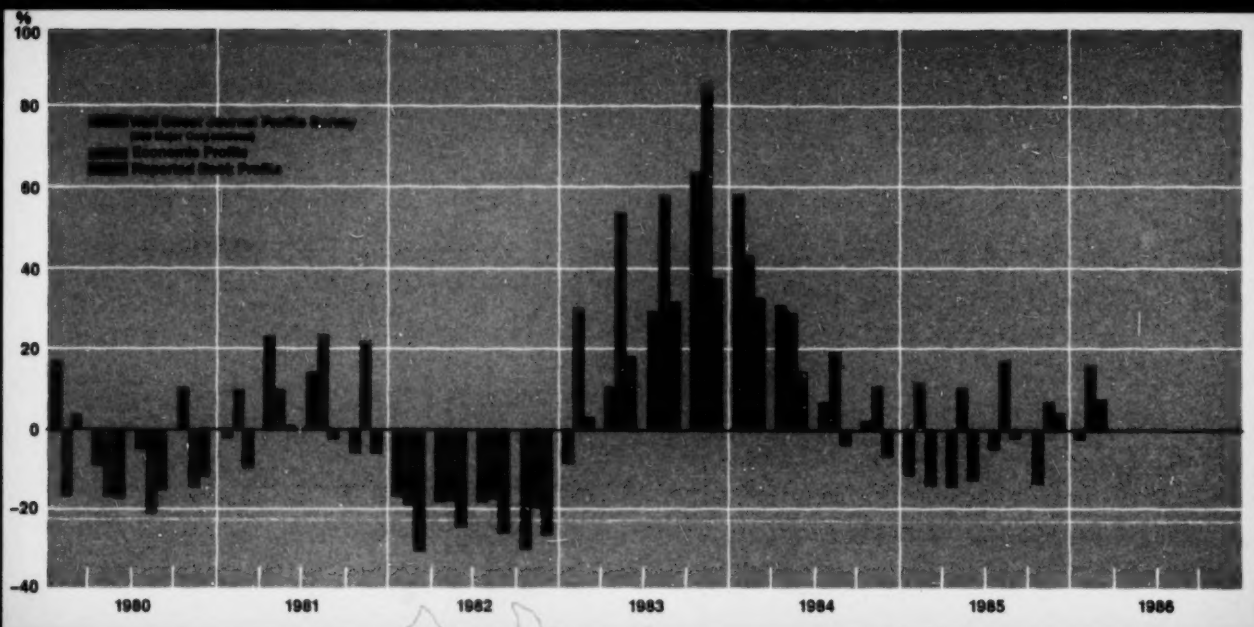
Faster depreciation allowances generated a huge surge in cash flow during the first half of the current expansion. This in turn fed the investment boom of that period. In the latter half of the recovery, cash flow growth slowed, leading to a somewhat disappointing investment performance.

NIA profits have been substantially stronger in the last few quarters than in survey reports such as those of the *Wall Street Journal*. One difference is that government figures cover a larger population. More importantly, the financial accounting results listed in the surveys generally recognize future expenditures earlier than the tax-based NIA measures. Expenditures associated with plant closings, company reorganizations, and future pension liabilities are recognized as a current expense in financial accounting but by the NIA only at the time the expenditures are actually made.

This difference in the timing of expense recognition can result in a substantial short-term divergence between financial and tax-based profit measures.

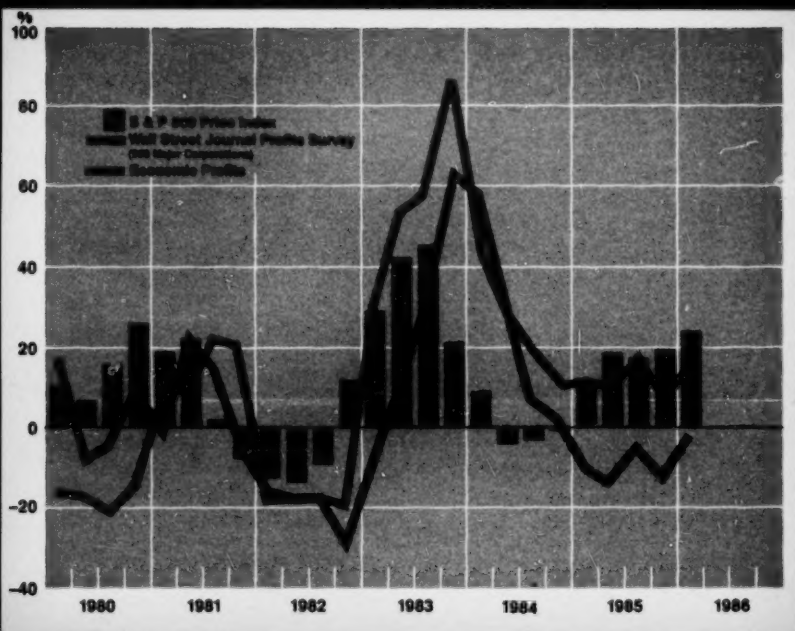
Different Measures of After-Tax Profits

Percent Change from Corresponding Quarter a Year Earlier



Stock Prices and After-Tax Corporate Profits

Percent Change from Corresponding Quarter a Year Earlier



That difference has resulted in special adjustments of more than \$21 billion in 1985, explaining most of the discrepancy between reported income and survey income. In addition, the accelerated depreciation charges allowed by the tax code do not figure in shareholder profits, although they raised economic profits.

Stock market expectations, including guesses about future profitability, can be seen by tracking changes in S&P 500 index against changes in corporate profits. On that basis, the stock market anticipates movements in corporate profits quite well.

Gerd Ull-Krueger

This Road Map was prepared with the valuable assistance of Kenneth A. Pritch of the Bureau of Economic Analysis.

Sources: U.S. Department of Commerce; The Wall Street Journal; Standard & Poor's; The Conference Board.